



Office of Inspector General Small Business Administration

March 2000 Update

Business Loans

In March, the Office of Inspector General (OIG) issued three audit reports as part of its ongoing program to audit SBA-guaranteed loans charged off or transferred to liquidation within 36 months of origination (early default). In all three cases, the loans were not originated in accordance with SBA rules and regulations or prudent lending practices. Other deficiencies were identified in the three audits and a synopsis of each audits follows.

- The lender neither verified the borrower's equity injection or personal financial information nor validated the financial information on a \$300,000 loan that defaulted in June 1998. The lender could not provide documentation that loan proceeds were used for the purposes designated by the loan agreement. When these facts were brought to the lender's attention, the lender relieved SBA of its obligation to honor a \$204,866 guarantee on this loan.
- The lender approved a \$350,000 to a borrower that lacked the ability to repay the loan, was not creditworthy at the time of loan origination, and lacked the financial assets to survive. The loan proceeds were used for the payment of delinquent taxes, which is an ineligible

purpose. Consequently, the SBA inappropriately paid the lender \$266,311 to purchase the loan guarantee. The district office agreed with the audit findings and the recommendation to issue a letter to the lender requesting a guarantee adjustment.

- The lender did not adequately secure a \$628,000 loan although the guarantor had sufficient assets for full collateralization. The lender also reimbursed the borrower for unallowable expenses. The audit also reported that the borrower made an inaccurate statement on the loan application and submitted invoices for personal expenses to support the loan disbursements. As a result, SBA lost \$479,890 when the defaulted loan was purchased. The district office has issued a demand letter to the lender to repay SBA the loan loss.

Audit Issued on Section 7(a) Loan Program.

On March 30, 2000, OIG issued an audit report on Section 7(a) fee collections. Under the Section 7(a) loan program, SBA guarantees loans made to small businesses by participating lenders. For loans approved after October 1995, lenders are required to pay SBA a yearly service fee equal to 0.5 percent of the outstanding balance of the guaranteed portion

of each loan. The audit objective was to determine if SBA collected the Section 7(a) loan service fees it was due for the period October 1995 through April 1999.

Overall, the audit showed that SBA collected the Section 7(a) service fees it was due for 95.5 percent of the 140,165 loans approved after October 1995, but that it may not have collected as much as \$4.1 million for the remaining 4.5 percent of those loans. In addition, errors in SBA records precluded accurate calculation of fees due and collected, incorrectly indicating fee overpayments on 5.5 percent of the loans. SBA was not able to ensure the collection of fees due for all loans and the accuracy of its records, because it did not have procedures in place to calculate amounts due for comparison with amounts collected, or to follow up with lenders on loans with significant differences. It did, however, have the information necessary to implement such procedures. OIG recommended that SBA establish receivable accounts and improve the processing management of Section 7(a) loan servicing fees. SBA generally agreed with OIG's recommendations.

Texas Coconspirators Indicted for Conspiracy, Making Material False Statements. Three persons associated with an automotive repair business in Irving, Texas, were indicted on March 8, 2000, on one count of **conspiracy** and 11 counts of **making material false statements** to induce a non-bank participating lender, and SBA to fund a \$156,000 SBA-guaranteed loan. The firm's proprietor, and his daughter, who is an employee, allegedly submitted 3 years of falsified "copies" of tax returns and forged Internal Revenue Service tax return verifications. A Grand Prairie, Texas, part owner of a business that sells automotive repair equipment, allegedly provided his coconspirators with bogus sales invoices and other bogus documentation of

their required capital injection and equipment purchases. SBA/OIG has conducted this continuing investigation jointly with the Department of Treasury's OIG for Tax Administration.

Disaster Assistance

California Man Convicted for Making Material False Statements. A Canoga Park, California, businessman was convicted on March 14, 2000, on both counts of **making material false statements** on which he had been indicted more than 1 year earlier. After the Northridge earthquake, he had obtained SBA disaster loans totaling \$55,700 for his Canoga Park, California, businesses. He also received a \$12,000 SBA disaster home loan for real estate and personal property losses to his apartment in Canoga Park. The investigation revealed that he failed to disclose to SBA that he had filed for bankruptcy in 1989 and 1990 under a different name and Social Security number. At the time he applied for the disaster loans, he also failed to inform SBA that he was on probation for a criminal offense. SBA/OIG joined the investigation, which was initiated by the Bureau of Alcohol, Tobacco, and Firearms, as an inquiry into possible arson and expanded to include the Social Security Administration's OIG. OIG agents arrested him in October 1999, after he failed to appear for his Federal trial on September 21, 1999. He is currently facing arson and insurance fraud charges in a separate State case filed in the Superior Court of Los Angeles County.

Surety Bonds

Texas Contractor Indicted for Making Material False Statements. The president of an Austin, Texas, pipe-installation contractor was indicted on March 7, 2000, on one count of **making material false statements** to SBA, to fraudulently influence SBA to guarantee a

\$510,000 surety bond. He allegedly answered negatively to having a criminal history on the SBA application. The investigation documented that he had been charged with, arrested, and/or convicted of at least nine criminal offenses. His company completed only a fraction of its bonded contract with a Department of Veterans Affairs hospital before defaulting. OIG initiated the investigation based on information forwarded by its Office of Security Operations concerning the results of a surety bond audit.

Entrepreneurial Development

Audit of an SBDC Identified Unallowable Costs. An audit of a Small Business Development Center (SBDC) identified \$31,892 of claimed costs that were unallowable under program guidelines. The costs included an improper travel reimbursement and unsupported in-kind contributions and payments to consultants. No repayment to the Small Business Administration (SBA) was necessary because the SBDC had provided more than the required 50 percent match of Federal funds.

The audit report also noted that the center overstated training and counseling accomplishments; did not perform client followup within the required time frame; made various errors in reporting program income; and did not maintain complete records for training activities, revenue deposits, and conference room rental agreements. The District Director agreed with all five findings identified in the audit and is currently taking corrective actions.

Agency Management and Financial Activities

SBA Receives Fourth Unqualified Financial Statement Opinion. SBA's FY 1999 financial statements received an unqualified opinion for the fourth straight year from the independent

auditors. The unqualified opinion means that the auditors found SBA's principal financial statements to be presented fairly in all material respects in accordance with Office of Management and Budget guidelines and SBA accounting policies. The results of the audit were transmitted to the CFO by OIG.

The auditors did, however, find two problems that were considered material weaknesses in the internal control structure: (1) SBA's financial reporting process did not ensure that its financial statements were free of material misstatements; and (2) significant general control deficiencies in its information systems continued to exist. OIG will issue separate reports on each of the material weaknesses that will include recommendations for improvement for both. A Management Letter outlined less significant findings with recommendations for Agency action.

Management Letter Issued on SBA's Financial Audit. OIG issued a Management Letter describing three conditions identified during the audit of SBA's FY 1999 financial statements. These internal control weaknesses were not included in the audit report on the financial statements because they were not material with respect to the statements. The first condition involved errors in the subsidy rate modeling and re-estimating process. This condition was reported in the FY 1998 Management Letter, and, while much improved, was not completely eliminated. The second condition was that SBA did not properly control computer equipment. The third condition involved duplicate payments made to SBDCs. In response to the Management Letter, the Chief Financial Officer (CFO) indicated that action has already begun to eliminate the three conditions for FY 2000.

Audit Report Issued on SBA's New Information Systems Development. OIG issued an audit report on SBA's proposed Systems Development Methodology. SBA's strategic goals depend heavily on the development of new information systems. In the past, however, SBA has been criticized for inadequate planning and poor systems development procedures. The Office of the Chief Information Officer is, therefore, developing a "Systems Development Methodology" (SDM) to help accomplish its strategic goals and address those criticisms. The SDM is a set of procedures and quality controls intended to reduce risks in the development of new systems and ensure that systems function as intended. The auditors found that the proposed SDM: (1) is generally consistent with Government and industry standards; and (2) will help ensure that new information systems are developed on time, within budget, and with the intended functionality. OIG recommended minor changes to the plan and that the Chief Information Officer establish the SDM as official Agency policy for system development projects. The report also contained a recommendation that milestones and responsibilities be established to ensure the completion of related standards and procedures. The Agency agreed with the recommendations in the March 30, 2000, audit report.

SBA IG Chaired Leadership Conference.

The SBA Inspector General chaired the 2000 Leadership Conference for Inspectors General (IG) in the Federal Government. The conference was held on March 9 and 10, 2000, at the Library of Congress. The theme of the conference was "The Evolving Role of the Inspector General in a New Millennium." The agenda covered several issues of concern to the IG community including: Preparing for the New Administration and Congress, IG Relationships with Stakeholders, and the Role

of the Oversight Community. The program was highlighted with notable speakers from the Administration, Congress, and the private sector.

The Activity Update is produced by the SBA/OIG, Phyllis K. Fong, Inspector General.

Comments or questions concerning this update or request for copies of OIG audits, inspections, or other documents should be directed to Bridget Bean, SBA/OIG, 409 Third Street SW., Washington, DC 20416-4110. Many OIG inspection and audit reports are available on the Internet at www.sba.gov/ig.

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